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In The

Supreme Court of the United States

October Term, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,

Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

MOTION FOR LEAVE TO FILE AND BRIEF OF CROWLEY MARITIME CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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MOTION FOR LEAVE TO FILE AS AMICUS CURIAE IN SUPPORT OF PETITIONER

Pursuant to Rule 37.2 of the Rules of this Court, *amicus*, Crowley Maritime Corporation ("Crowley"), respectfully moves this Court for leave to file the attached Brief as *Amicus Curiae* in Support of the Petition for Writ of Certiorari. The consent of the attorney for the Petitioners herein has been obtained, but the attorney for the Respondents herein has refused to consent to the filing of a brief by Crowley as *amicus curiae*.

The applicant, Crowley, is a closely held corporation that has tentatively approved the adoption of a stock savings plan that stands to benefit its employees. As a closely held corporation, Crowley shares a concern in the significant burden that the Ninth Circuit's decision imposes on fiduciaries who are not themselves professional valuators of closely-held stock.

If the stock savings plan is implemented, annual valuations of Crowley common stock will be required for routine annual transactions such as the purchase of shares of capital stock, possibly both from majority and minority shareholders of the company, as well as from retiring participants. Valuations would also be required if other, less routine transactions involving shares of capital stock were to occur. The Board of Directors, each of whom would become a fiduciary under ERISA if the stock savings plan is implemented, consists of only one employee of Crowley and a number of outside directors. None of the directors has expertise in the valuation of closely-held shares of capital stock. Crowley is concerned that the Ninth Circuit's decision in this case will make it

difficult for Crowley to retain and attract qualified directors with business experience at a high level.

Crowley submits that the decision of the Ninth Circuit creates a conflict between the circuits regarding the required fiduciary duty of prudence under Section 404 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (29 U.S.C. § 1104). The issues relate to the sale of stock between an employee stock ownership plan or profit sharing plan and a party in interest when the sale must be for "adequate consideration" as defined in Section 3(18) of ERISA (29 U.S.C. § 1002(18)).

Crowley stands to be particularly affected by the decision below in its attempt to implement a stock savings plan. The issues presented by this case are of exceptional importance to Crowley in that Crowley seeks to be able to establish and operate an employee benefit plan utilizing employer stock in circumstances where its fiduciaries are subject to the same clearly identifiable standards of prudence and care applicable in the other circuits. Crowley's brief traces the body of law and administrative regulations that have developed under ERISA regarding prudent selection of expert advice and reliance on the advice of those experts in arriving at the value of a closely-held company. Crowley believes this discussion, focusing on the contexts of ERISA and closely-held companies, will be useful to the Court in addressing the issues presented. Crowley therefore

respectfully seeks leave of this Court to file the attached brief in support of the Petition for Writ of Certiorari.

Dated: April 29, 1997

Respectfully submitted,

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BRIEF OF CROWLEY MARITIME CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

PRELIMINARY STATEMENT

Crowley Maritime Corporation ("Crowley") submits this brief as *amicus curiae* in support of Petitioner in this proceeding. Respondents Newman Howard, Gilbert Leon Allen, Joan Howard and Theodore H. Pope as representatives of plan participants similarly situated on behalf of the employee stock ownership of Pacific Architects and Engineers Incorporated, ("Respondents") declined to consent to the filing of this brief. Accordingly, it is accompanied by a Motion for Leave to File As Amicus Curiae In Support of Petitioner.

INTEREST OF AMICUS CURIAE

Crowley is a diversified marine transportation company providing transportation services in domestic and international markets, employing more than 5,000 employees and more than 200 tugs, barges, roll-on/roll-off ships and container ships. Its principal executive offices are located at Oakland, California. A majority of shares of capital stock of Crowley are owned by members of the Crowley family, but, in addition there are approximately 123 public shareholders and an inactive employee benefit plan which continues to hold shares of capital stock. Such shares are not listed on a national securities exchange and there is no established public trading market for them, although quotations for shares of Crowley common stock may be obtained in the "pink sheets" or otherwise.

At its meeting on February 27, 1997 the Board of Directors of Crowley tentatively approved adoption of a new stock savings plan intended to instill in its employees pride of ownership in the company while providing them a form of deferred compensation and retirement benefits. It is contemplated the plan will qualify under Section 401(a) of the Internal Revenue Code as a profit sharing plan and that funds contributed to the

plan will be primarily invested in shares of common stock of Crowley. Depending on the resolution of issues such as those raised by the decision of the Ninth Circuit in this case, Crowley in the future may decide to limit the contributions it makes to a stock based plan or to consider curtailing it altogether.

If the stock savings plan is implemented, annual valuations of Crowley common stock will be required for routine annual transactions such as the purchase of shares of capital stock, possibly both from majority and minority shareholders of the company, as well as from retiring participants. Valuations would also be required if other, less routine transactions involving shares of capital stock were to occur. The members of the Board of Directors, each of whom would become a fiduciary under ERISA if the stock savings plan is implemented, consist of only one employee of Crowley and a number of outside directors. None of these directors has expertise in the valuation of stock. Crowley is concerned that the Ninth Circuit's decision in this case will make it difficult for Crowley to retain and attract qualified directors with business experience at a high level.

SUMMARY OF ARGUMENT

The Employee Retirement Income Security Act of 1974, as amended ("ERISA")[1] clearly permits an employer to engage in the purchase or sale of employer stock with a profit-sharing plan or an employee stock ownership plan ("ESOP") if certain conditions are met. Specifically, the sale of stock between an employee stock ownership plan or profit sharing plan and a party in interest is permitted if the sale or purchase is for "adequate consideration", as defined in Section 3(18) of ERISA (29 U.S.C. § 1002(18)), and if the sale or purchase is

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[1] Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of U.S.C.) (1974).

otherwise prudent under Section 404 of ERISA (29 U.S.C. § 1104).

Because the vast majority of individual fiduciaries are not experts in the valuation of closely-held companies, they principally rely on the advice of an independent valuator in prudently arriving at a price that meets the standards for "adequate consideration."

Crowley files this *amicus curiae* brief because the position of the Ninth Circuit Court of Appeals would make any establishment of a plan subject to ERISA that holds Crowley stock problematic to say the least, because the method for determining adequate consideration that is suggested by the Ninth Circuit is unclear and would not appear to work at a practical level. As a result, the Ninth Circuit Court's ruling would make it virtually impossible for the fiduciaries of Crowley's plans to know whether they have met their fiduciary duties whenever an issue arose concerning the valuation of Crowley stock.

Standing in contrast to the Ninth Circuit's decision is the substantial body of law developed since ERISA's enactment that permits, even requires, fiduciaries to rely on the advice of an expert in arriving at the value of a closely-held company. Until the Ninth Circuit decision came down, this body of law could have been relied upon by Crowley and virtually every other closely-held company that has established an ESOP or profit-sharing plan holding employer stock.

Because of the conflict between circuits created by the Ninth Circuit's decision, and the significant burden that its decision imposes on fiduciaries who are not themselves professional valuators of closely-held stock, Crowley urges this Court to grant the Petition for Certiorari in this case, and to reverse the erroneous holdings of the Ninth Circuit.

ARGUMENT

I. Petitioner Met The Requirements Of Prudence And Adequate Consideration Imposed By ERISA On Fiduciaries Who Authorize The Sale Of Company Stock From A Plan To A Party In Interest.

With one decision the Ninth Circuit has expanded beyond the limits set by any other court the expertise required of fiduciaries who act on behalf of plans that buy or sell stock of the employer sponsoring the plan. This expansion of personal liability to fiduciaries is not only unwise from a policy standpoint, since it will greatly discourage the implementation of employee benefit plans that Congress has sought to encourage, but also is clearly contrary to the case law developed in other circuits and to relevant statutes and regulations.

In the present case, even though Petitioners had selected and relied on the advice of an expert (Arthur Young & Company) in the determination of the value of the ESOP's company stock holdings, the Ninth Circuit found that such reliance did not meet the requirements of prudence and adequate consideration imposed by ERISA. The Ninth Circuit so held despite having no quarrel whatsoever with the selection of an independent and major accounting firm's valuation group and while recognizing that such firm was provided with all facts relevant to the making of the valuation in question. Instead, the Ninth Circuit held that Petitioners did not satisfy their duties under ERISA because they did not second-guess the application of certain discounts that Arthur Young had used to value the company stock held by the ESOP. Thus, the Ninth Circuit's opinion rests on its conclusion that fiduciaries must question the underlying methodology used by a competent independent valuator of closely-held stock.

Many employers rely in good faith on the advice of an independent valuator, exactly as Petitioners did, and

based on court decisions, revenue rulings and Proposed Regulations, have always assumed that their conduct was reasonable and within the law. Crowley was planning to do exactly that with its newly contemplated plan, but now the Ninth Circuit's ruling potentially subjects individual fiduciaries of ESOPs or other plans containing employer stock to personal liability for such behavior – notwithstanding that it was widely believed before now to be clearly in accordance with the adequate consideration standard and within the boundaries of what is considered prudent under ERISA.

The "prudence" requirement of ERISA is contained in ERISA § 404(a)(1) (29 U.S.C. § 1104(a)(1)) which provides, in relevant part, that a fiduciary must discharge its duties with respect to a plan:

> solely in the interest of the participants and beneficiaries and –
>
> . . .
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. . . .

In regulations issued shortly after ERISA's enactment in 1974, the Department of Labor ("DOL") interpreted the prudence requirements of the statute quoted above and specifically allowed a fiduciary to rely on experts:

> A plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention if, in the exercise of ordinary care in such situation,

> he has no reason to doubt the competence, integrity or responsibility of such persons.

29 C.F.R. § 2509.75-8 FR-11 (1996).

While the regulations quoted above are general in scope, and so do not speak specifically to the issue of retaining an expert to value the stock of a closely-held company, they do clearly permit a fiduciary to rely on the analyses of non-fiduciaries, and specifically provide that the fiduciary has met its fiduciary duties if, in the exercise of ordinary care, it has no reason to doubt the competence, integrity or responsibility of the expert. Under ERISA Section 404's prudence requirement, a fiduciary retaining an expert is not required to second-guess the expert's analyses or reports; all that is required of the fiduciary under ERISA is prudently to select the expert and then monitor the expert, using ordinary[2] (not extraordinary) care to ensure that it has no reason to doubt the expert's competence, integrity or responsibility.

Parallel to the prudence rules described above are the prohibited transaction rules of ERISA, and the exceptions to those rules dealing directly with the issue of valuing stock in a closely-held company. ERISA Section 406 (29 U.S.C. § 1106) generally prohibits transactions between a plan and a "party in interest", such as Petitioners, but makes an exception under ERISA Section 408(e) (29 U.S.C. § 1108(e)) for the acquisition or sale by a plan of qualifying employer securities "if such acquisition [or] sale . . . is for adequate consideration," among other requirements not here relevant.

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[2] *See Donovan v. Cunningham*, 716 F.2d 1455, 1467 n.26 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984), rejecting the suggestion that ERISA's fiduciary standards requiring "a prudent man familiar with such matters" creates a "prudent expert" standard.

"Adequate consideration", in turn, is defined by ERISA Section 3(18) (29 U.S.C. § 1002(18)) in relevant part as:

> in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

The Preamble to the Proposed Regulations issued by the DOL defining "adequate consideration" states that determining adequate consideration is a two-step process, (1) fair market value, and (2) good faith:

> First, the value assigned to an asset must reflect its fair market value as determined pursuant to proposed § 2510.3-18(b)(2). Second, the value assigned to an asset must be the product of a determination made by the fiduciary in good faith as defined in proposed § 2510.3-18(b)(3).

53 Fed. Reg. 17,633 (1988) (Preamble).

For purposes of the fair market value requirement in determining adequate consideration:

> "fair market value" . . . means the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.[3]

53 Fed. Reg. 17,637 (1988) (to be codified at 29 C.F.R. § 2510.3-18(b)(2)) (Proposed May 17, 1988).

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[3] This was the standard used by Arthur Young in its valuation of the stock in question.

In discussing the fair market value requirement just quoted, the Preamble strongly encourages fiduciaries to rely on experts when it states that "the extent to which the Department will view a valuation as reflecting fair market value will be affected by an assessment of the level of expertise demonstrated by the parties making the valuation". 53 Fed. Reg. 17,634 (1988) (Preamble).

After discussing the fair market value requirement, the Preamble discusses the good faith requirement that applies where the fiduciary itself makes the evaluation, and when an independent valuation should be obtained to meet that requirement:

> [T]his section states that either the fiduciary making the valuation must itself be independent of all the parties to the transaction (other than the plan), or the fiduciary must rely on the report of an appraiser who is independent of all the parties to the transaction (other than the plan).

53 Fed. Reg. 17,634 (Preamble).

Therefore, the Proposed Regulations under ERISA Section 3(18) actually *require* the fiduciary who is not independent to rely on the advice of an independent expert in determining adequate consideration ("the fiduciary making the valuation . . . *must rely on the report of an appraiser who is independent"*). Likewise, as demonstrated above, DOL regulations state that a fiduciary meets its prudence obligation under ERISA by relying on the analyses of a prudently retained expert.

Until now, the case law was in harmony with the regulations. That is because until the Ninth Circuit's decision, courts uniformly held that both the prudence requirement and the adequate consideration requirement under ERISA are met when a fiduciary responsible for valuing the stock of a closely-held company relies in good faith on the advice of an independent expert.

The case law strongly encourages fiduciaries who make difficult decisions on behalf of a plan, including decisions as to the value of company stock, to make use of the skills of an expert. *Katsaros v. Cody*, 744 F.2d 270 (2d Cir. 1984), *cert. denied, Cody v. Donovan*, 469 U.S. 1072 (1984) (trustees breached their duty in failing to seek outside expert); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984), *on remand*, 619 F. Supp. 154 (N.D. Ill. 1985), *and on remand*, 669 F. Supp. 1390 (N.D. Ill. 1987), *aff'd*, 858 F.2d 361 (7th Cir. 1988), *cert. denied, Johnson v. Engle*, 489 U.S. 1078 (1989) (fiduciary duties breached where administrators of profit sharing plan failed to seek independent advice before purchasing stock); *Ershick v. UMB*, 12 E.B.C. 2323 (D. Kans. 1990), *aff'd*, 948 F.2d 660 (10th Cir. 1991) (directed trustee's reliance on an independent appraiser to value company stock fully discharged its responsibility). Thus, in undertaking the sale or purchase of company stock on behalf of a plan, non-independent fiduciaries are required by regulations and the courts to hire and rely on experts, and failure to do so will result in fiduciary breach. Therefore, Petitioners' reliance on Arthur Young to value the stock is not only permitted, but appears to be required.

Of course, if a fiduciary attempted to influence the outcome of an expert's valuation report, a court could find inadequate consideration or fiduciary breach based on a lack of good faith. But where, as in the Ninth Circuit's decision here, the court does not find clearly erroneous the district court's holding that the sale of stock was conducted in good faith, a finding of fiduciary breach or lack of adequate consideration is virtually always limited to situations relating to the inadequate *factual basis* of the valuator's opinion and not, as the Ninth Circuit has held, to an analysis of the underlying methodology or discount rates by which the valuator arrived at the value.

The Ninth Circuit's ruling makes the requirement of relying on an expert rather meaningless, because it requires the fiduciary itself to have enough expertise to question the expert's methodology, the very skill that is admittedly within the expertise of the expert, and not within the knowledge of the fiduciary. How could a company such as Crowley qualify when it has no valuation experts on its Board? Are such companies precluded from having employer stock based employee benefit plans unless they put valuation experts on their boards? These are very real questions for Crowley. Is Crowley therefore precluded from having a stock-based benefit plan?

This is a very bad result given that the rule enunciated by the Ninth Circuit is simply not the rule contained in the statute or regulations. Prior to the decision of the Ninth Circuit, employers and practitioners alike widely believed *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984), to be the leading case in this area. In *Cunningham*, where ESOP fiduciaries were found to have breached their fiduciary duties by purchasing stock on behalf of the ESOP for more than adequate consideration, the court held that:

> ESOP fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing.

Id. at 1467-68 (footnote omitted).

The *circumstances* that the fiduciaries failed to investigate prudently in *Cunningham* were the *factual* bases underlying the valuation report:

> The insufficiency of appellees' investigation lies in their failure to identify the facts and assumptions underlying the Rotan Mosle appraisal and to consider whether they

> remained valid at the time of the ESOP transactions. Cursory study of Rotan Mosle's report would have shown that they did not in several material respects.
>
> . . . .
>
> To sum up, we hold that appellees Cunningham, Fritcher, Hairell, Robertson and Esparza failed to conduct an investigation sufficient to determine if the Rotan Mosle appraisal remained a reasonable approximation of the fair market value of MCS stock at the times they relied on it. Two critical assumptions made by Rotan Mosle – the growth projections and the absence of an ESOP – no longer were valid.

Id. at 1469-70 and 1473 (footnote omitted).

Most importantly, in demonstrating the direct conflict with the Ninth Circuit, the Fifth Circuit rejected the Deparment of Labor's attempt to obtain a ruling from the court that the fiduciaries breached their duties as the result of the discounts used by the valuator:

> The Secretary also urges us to hold that ESOP fiduciaries must always discount the appraised price of a controlling block of stock when less than control is acquired by the ESOP. The Secretary bases his discount argument upon Revenue Ruling 59-60 which sets out principles for valuing closely-held stock for estate and gift tax purposes. . . .
>
> Judicial adoption of this revenue ruling is no substitute for the regulations the Secretary has never promulgated; we are unwilling to hold that ERISA fiduciaries who fail to follow it jot and tittle have breached their duties. Appraisal of closely-held stock is a very inexact science; given the level of uncertainty inherent in the process and the variety of potential fact patterns, we do not think a court should require

> fiduciaries to follow a specific valuation approach as a matter of law under Section 3(18).

Id. at 1472-73 (footnotes omitted).

Like many cases before it, the Ninth Circuit quotes the "magic wand" passage from the *Cunningham* decision, but then inexplicably, and unlike any case before it, the Ninth Circuit totally disregards what *Cunningham* says in that passage. *Cunningham* holds that fiduciaries in stock valuation cases do have a duty – to make sure that the facts used by the valuator are complete, accurate and up to date, but they are not required to second-guess the methodology used by the valuator, and thus by relying on the expert are completely within the prudent performance of their fiduciary duties:

> The appraisal represented a quantitative analysis of specific facts and assumptions. Prudent fiduciaries would have sought to analyze the effect of obvious changes in those facts and assumptions – either by their own efforts or with the help of advisors. An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly. To use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock – they are entitled to rely on the expertise of others. . . . However, as the source of the information upon which their experts' opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date. In failing to do so, the appellees breached their duties of prudence under Section 404 and likewise cannot establish that they paid adequate consideration. Accordingly, the ESOP transactions also were prohibited by Section 406.

Id. at 1474.

Therefore, although obtaining the advice of an independent expert as to the valuation of closely-held company stock is not a complete defense to allegations of imprudence or lack of adequate consideration under ERISA, neither *Cunningham* nor any other case of which Crowley is aware, except the Ninth Circuit's recent decision, holds that good-faith reliance on the advice of an expert who was qualified to conduct an appraisal and who had complete, accurate and up to date data could be found to have been imprudent or not to have satisfied the adequate consideration requirement.

Recently, the Seventh Circuit has re-confirmed the view taken in *Cunningham* that fiduciaries who hire experts to value closely-held stock are entitled to rely on the expert's opinion, without any requirement that they themselves become experts who must undertake a critique of the valuator's methodology; provided only that the facts relied upon by the valuator are accurate and up to date.

In *Eyler v. Comm'r*, 88 F.3d 445 (7th Cir. 1996), Eyler, the majority owner of a closely-held company, sold $10 million worth of stock to the corporation's ESOP at a $14.50 per share price, which was based on a price range that Pru-Bache had determined as the underwriter for an initial public offering of the company. After the attempted offering failed due to the lack of interest by potential investors in the stock at $14.50 per share, the company sold the stock to the ESOP at that price.

Affirming a ruling of the tax court that the $14.50 per share price paid by the ESOP was in excess of adequate consideration, the Seventh Circuit emphasized that "the adequate consideration test focuses on the conduct of the fiduciaries in determining the price, not the price itself." *Id.* at 455.

In applying this standard, the basis of the court's decision that the adequate consideration standard had not been met was that the board failed to correct faulty

factual assumptions upon which the valuation was based. The court found that the board, acting as fiduciary, had arrived at a price relying only on a financial consultant, who had prepared no valuation report, and the Pru-Bache letter, which, as the court noted, "was nearly four months old and prepared for an IPO that was subsequently shelved." *Id.* at 455. The court noted further that:

> the Pru-Bache valuation was based on underlying assumptions that significantly changed by the time of the board meeting. The major assumptions included the absence of an ESOP and its accompanying contributions and loan guarantee, and the influx of millions of dollars of cash as a result of the IPO. . . . The record is devoid of any evidence that the board gave proper consideration to the effect of any of these intervening factors.

Id. at 455.

As shown above, Department of Labor regulations and cases uniformly encourage fiduciaries to hire and rely on experts for the purpose of valuing the stock of closely-held companies. The ruling of the Ninth Circuit clearly conflicts with both the Fifth and Seventh Circuits and, if allowed to stand, fundamentally changes the duties of a fiduciary seeking to fulfill its responsibilities under ERISA to properly value closely-held stock.

Whereas before the Ninth Circuit's ruling a fiduciary was required only to prudently select a qualified independent valuator, permit that valuator to function independently of any inappropriate pressures or influences and ensure that the factual basis for the valuator's decision was complete, accurate and up to date; now according to the Ninth Circuit, the fiduciary must substitute its own opinion for the opinion of the expert on the value of the shares. If any "uncertainties" exist, then the fiduciary is required to hire a second expert.

Nowhere in the Ninth Circuit's decision is there an explanation as to how this new rule would operate. To protect itself from allegations of fiduciary breach, the individual fiduciary would essentially have to hire at least two valuators in every case, and each valuator would have to base its valuation opinion on the facts, without regard to the methodology used by the other valuator. Not only does this double the cost that the employer must devote to experts, nowhere in ERISA is there a hint of such a requirement. Because the employer ordinarily bears the cost of establishing any employer stock based employee benefit plan and also funding it, the Ninth Circuit's ruling, even for the brave employer who attempts to follow it, will cause the employer to have less money available to contribute to such a plan as benefits for employees.

Furthermore, and perhaps more importantly, it is unclear what the fiduciary should do if, as will certainly almost always be the case, the two experts do not agree on the value of the closely-held shares. As noted in *Cunningham*, "Appraisal of closely held stock is a very inexact science." *Id.* at 1473. At this point is the employer required to hire a *third* valuator to see which is more nearly correct? Or is the employer required to average the difference in value arrived at by the original two valuators? These questions remain unanswered and, as a practical matter, put fiduciaries who act on behalf of plans holding company stock at severe risk for performing tasks that are clearly permitted under ERISA and that, prior to the Ninth Circuit's ruling, were duties that the fiduciary could take practical, prudent and clearly identifiable steps to meet.

The rule enunciated by the Ninth Circuit, however, makes it perilous indeed for a fiduciary who decides to act on behalf of a plan purchasing or selling company stock, for the fiduciary itself must now essentially be a

valuation expert in order to comply with the Ninth Circuit's requirement that it adequately critique the report prepared by the professional valuator. It simply does not make sense to encourage fiduciaries on the one hand to hire and rely on independent appraisers to value company stock, and then to penalize them, as the Ninth Circuit has done, for doing just that.

As stated in *Cunningham*:

> On the one hand, Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal. Competing with Congress' expressed policy to foster the formation of ESOPs is the policy expressed in equally forceful terms in ERISA: that of safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility. . . .
>
> Our task in interpreting the statute is to balance these concerns so that competent fiduciaries will not be afraid to serve, but without giving unscrupulous ones a license to steal. More, though we are guided by principles of trust law, we must bear in mind that in ERISA Congress departed from the absolute common law rule against fiduciaries' dual loyalties. ERISA clearly provides that a fiduciary may be an officer or employee of the company whose securities he purchases on behalf of a plan. Thus the stringent prophylactic rules of the common law cannot be incorporated reflexively under the statute.

Id. at 1466-67 (footnotes and citations omitted).

II. Under ERISA, Whether Adequate Consideration Has Been Received By A Plan In Its Sale Of Company Stock Does Not Vary Depending On Whom The Buyer Is.

In its decision, the Ninth Circuit holds that a prudent fiduciary would have questioned the application of a minority discount to the stock sold by the ESOP to the party in interest, even where the ESOP's interest unquestionably represented a minority interest in the company. What the court believed was inappropriate was the application of a minority discount to the stock holdings of a stock-based benefit plan where the party in interest, as purchaser, already had control of the company *before* making its purchase from the plan:

> Second, Arthur Young applied a minority interest discount . . . and it assumed that Shay was entitled to the full benefit of this discount even though, once purchased, the ESOP's minority block would merge with his controlling block and he would capture all of the increased value. A prudent fidicuary would have questioned these assumptions.

Howard v. Shay, 100 F.3d 1484, 1489 (9th Cir. 1996).

Practical applications of the Ninth Circuit's view on this issue lead to absurd results. For example, assume that on one day an employer stock based plan sold equal amounts of stock to two buyers, one a majority stockholder of the company and the second a new buyer. Under the Ninth Circuit's rationale the fiduciary of the plan would be imprudent unless it obtained a premium from the majority stockholder but would not be committing a breach to sell the very same stock on the same day to the new buyer without obtaining such a premium.

While there is ample support for the idea that the sale of control of a company should command a premium, there is no basis in prior case law, the Proposed Regulations or logic for a rule that when literally applied

would result in a higher price being obtained by the plan for the same stock depending on what the buyer's existing stockholdings are. Whatever value can be attributed to control of the company was *already owned* by the party in interest *before* it purchased stock in the ESOP. Since the party in interest already *had* control of the company, the additional stock it bought from the ESOP did not add to or detract from that control. Thus, it makes little sense to require the ESOP to extract extra money from the party in interest based on control of the company, when that is something the party in interest already owns, and something the ESOP is not selling.

To take the example one step further, after paying a control premium for a minority block of stock on day one, suppose that the majority shareholder sells some of that stock back to the plan the next day. After purchasing the stock for a control premium on one day, can the majority shareholder then sell the very same stock back to the plan for the same price on the very next day? Not under the Ninth Circuit's ruling, unless the plan is a majority shareholder. Of course, the stock's value did not change between day one and day two, and yet the Ninth Circuit's holding would seem to require the parties to ignore this obvious economic reality.

As discussed above, a sale of stock by a party in interest to an employer stock based employee benefit plan, or vice-versa, is exempt from the prohibited transaction rule of ERISA Section 406 (29 U.S.C. § 1106) if the sale of stock is for "adequate consideration." In the context of close corporations, there is often no reliable history of actual sales and therefore, the valuation of stock is difficult. The DOL's Proposed Regulations defining "adequate consideration" provide that:

> "fair market value" . . . means the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter

> is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such an asset.

53 Fed. Reg. 17,637 (to be codified at 29 C.F.R. § 2510.3-18(b)(2)) (Proposed May 17, 1988).

Thus, in accordance with business reality, the adequate consideration requirement for purposes of ERISA has uniformly been interpreted to mean fair market value, defined as the price at which property would change hands between a *hypothetical* willing buyer and a *hypothetical* willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. *See, e.g., Eyler v. Comm'r,* 88 F.3d 445, 451 (7th Cir. 1996) (The requirement of fair market value "has been interpreted repeatedly by the IRS and the courts as requiring that the willing buyer and seller be *hypothetical.*") (emphasis added); *Reich v. Valley National Bank of Arizona,* 837 F. Supp. 1259 (S.D.N.Y. 1993) (holding that purchase of stock by ESOP was for more than adequate consideration where fiduciary did not refer to a *hypothetical* buyer, but rather, analyzed the investment in terms of the same conditions paid by the ESOP); *Capital City Excavating Co. v. Comm'r,* 47 T.C.M. 1527, 1530 (1984) (In the context of closely-held corporations, "shares must be valued on the basis of what willing buyers and willing sellers would be likely to pay or to accept in *hypothetical* sales.") (emphasis added).

In its decision, the Ninth Circuit has totally failed to follow the well-established *hypothetical* willing buyer and seller approach and instead has invented a new requirement for the application of minority discounts in sales between plans and parties in interest that is contrary to logic and to virtually every other case that has ruled in this area. This, of course, creates a major conflict with these other circuits. The Ninth Circuit's decision also illustrates the inadvisability of requiring fiduciaries to

question the methodology of a valuation expert. What may at first seem obvious to a non-expert can easily, upon further analysis, turn out to be dead wrong. Fiduciaries who make such mistakes in questioning an expert's valuation opinion may conclude in light of the Ninth Circuit's decision that to fulfill their fiduciary duties they must disregard the opinion of the expert, and end up like the Ninth Circuit has by making a grievous error in valuation that reliance on the expert would have prevented.

CONCLUSION

For all the reasons set forth above, Amicus Curiae Crowley Maritime Corporation urges the Court to grant certiorari in this case, and to overturn the erroneous holdings of the Ninth Circuit Court of Appeals.

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Respectfully submitted,

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